# *Missouri Tax Credits Report*

## *JOINT COMMITTEE ON TAX POLICY*

**Representative Mike Sutherland, Chair**
**Senator Michael R. Gibbons, Vice-Chair**

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**November 15, 2006**

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## Background

A tax credit is treated as a reduction for taxes owed. Generally, it is awarded by a government entity to a private entity in exchange for a predetermined outcome. Tax credits can be characterized, according to the Department of Economic Development, as one of three types of credits: economic benefit credits, quality of life (social benefit) credits, or a hybrid credit of which the intention is to produce economic benefit as well as to increase the quality of life.[1]

The first tax credit program initiated in Missouri, the Neighborhood Assistance Program, was created in 1977. Since then, Missouri has steadily increased the number of tax credit programs along with a dramatic increase of tax credit programs in the late 1990s, when Missouri's economy was booming. As of today, there are fifty-three[2] tax credit programs in existence with some of the caps of the programs exhausted and therefore unable to operate until the caps are increased.

## Features of Tax Credits

Missouri tax credits are structured with different features. These features are not standardized among the programs and may vary with each specific credit.

### *Carry-back Provision*

This feature allows the taxpayer to apply the tax credit against taxes that have already been paid or that are owed from previous tax years. In essence, the taxpayer can receive a refund for the amount of the credit used toward tax liability in previous tax

[1] The classification of tax credits was taken from the Missouri Incentives Review Committee Report, released in November of 2005. This report was provided to the committee in December of 2005.
[2] This number is disputable depending on how the programs are classified. There are 62 incentive programs according to the Missouri Incentives Review Committee Report, though not all of these programs award tax credits. The true number of tax credits, however, is in the low to mid –fifties.

years. Those credits that have a carry-back provision have a standard carry-back length of up to three years.[3]

***Carry-forward Provision***

This feature allows the taxpayer claiming the credit to apply the credit to the taxpayer's tax liability in future tax years. Unlike the carry-back provision, there is no standard length of time for the carry-forward provision. The length of time of the carry-forward provision (for those credits that have this provision) ranges from four years to (in one credit's case) unlimited.[4]

***Refundable***

Some tax credits may be refundable, meaning that should the amount of the tax credit exceed the taxpayer's tax liability, the remaining amount of the tax credit is viewed as an overpayment of taxes and therefore can be awarded to the taxpayer as a refund.[5]

***Transferable***

Many of the tax credits can be sold or assigned to a different taxpayer. Evidenced through a certificate, these credits are often sold for less than its full value so that the taxpayer that sells the credit realizes the benefit of immediate capital.

***Recapture***

Some state tax credits have a recapture provision, meaning that if the entity who is awarded the credit does not meet the obligations of the program, the state has the right to recapture or take back the credit that was awarded.

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[3] For a list of those credits that have a carry-back provision, please refer to the EXCEL spreadsheet included as Appendix A in the report. This EXCEL spreadsheet does not have the credits that were established in the 2006 legislative session. This spreadsheet was provided by Paul Rothstein and Nathan Weininger of Washington University.

[4] One credit, the Disabled Access Tax Credit has an unlimited carry-forward provision. For each specific credit's carry-forward provision, please refer to the EXCEL spreadsheet included as Appendix A.

[5] For a list of tax credits that are refundable, please refer to the EXCEL spreadsheet included as Appendix A.

***Entitlement vs. Discretionary Credits***

Tax credits can either be entitlement credits or discretionary credits. Entitlement credits must be awarded to the taxpayer that meets the requirements of the tax credits. In the case of tax credits that are discretionary, the taxpayer must still meet the qualifications of the tax credit program; however, the agency charged with the program's administration has discretion in deciding which taxpayer is awarded the credit.

***Contribution Tax Credits***

The amount awarded for some tax credits are based on the amount of private expenditures invested in a specific project. Other programs are generally geared toward "social" (quality of life) purposes and the amount awarded is based on the amount of contributions given to the cause (generally the amount awarded via tax credit is 50% of the donation).

***Caps on Tax Credits***

Many of the tax credits have caps on the amount of money that can be awarded. The type of cap depends on the individual tax credit program. Credits with annual caps have a predetermined amount each year that can be awarded through the program.[6] Credits with cumulative caps have a predetermined amount that can be awarded through the course of the program's life. Some of the credits' cap amounts are determined annually through the legislature's appropriation process each year. Some of the tax credits are interrelated because their cap amounts are subject to the availability of funds in a single pool of money. Also, many of the tax credits do not have a cap at all.[7]

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[6] The Infrastructure Development Fund Contribution Tax Credit's annual cap may be exceeded with the combined consent of the Commissioner of Administration, the Director of the Department of Economic Development, and the Director of Revenue. Section 100.286.6, RSMo.

[7] For a specific credit's cap feature, please refer to the EXCEL spreadsheet included as Appendix A.

## Alternative Minimum Tax

The Alternative Minimum Tax, popularly cited as AMT, was created in the Federal Internal Revenue Code in 1969 and first implemented in 1970. The idea behind this alternative tax was to prevent those taxpayers with extraordinary incomes from taking advantage of the many deductions and exemptions allowed by the internal revenue code so that all taxpayers pay something.[8]

The IRS requires certain taxpayers to first calculate their tax liability under normal circumstances and then calculate their tax liability under the Alternative Minimum Tax (eliminating certain deductions and exemptions). Should the tax liability under the Alternative Minimum Tax exceed the tax liability calculated under normal circumstances, then the taxpayer would have to meet the difference between the two calculations. This difference would then be credited to the taxpayer's tax liability in those future years where the Alternative Minimum Tax was not a factor in determining tax liability. Essentially, those taxpayers that perpetually calculate their federal income tax liability with the Alternative Minimum Tax continually build credits to off-set future federal income tax liability.

The Alternative Minimum Tax used to affect only a small amount of taxpayers, yet not indexing for inflation coupled with the federal tax cuts enacted in 2001 has recently caused many more taxpayers to come under the Alternative Minimum Tax umbrella. The AMT tax has important considerations for Missouri's state tax credits because one of the deductions eliminated under the federal AMT calculation is the deduction for state income taxes paid.

[8] A Congressional Budget Office brief of the Alternative Minimum Tax is included as Appendix F.

**Tax Credit Accountability Act (2004)**

In 2003, the St. Louis Post Dispatch reported widespread abuse in regards to one of Missouri's tax credit programs, the Rebuilding Communities Tax Credit Program. Testimony from the Attorney General's Office, the State Auditor's Office, and the Department of Economic Development led to a reform of the statutes concerning tax credits to increase accountability, effectiveness, fiscal responsibility, and public benefit. The following changes were implemented as a result of the Joint Committee on Tax Policy's work:

1. The Joint Committee on Tax Policy is required to automatically review any audit conducted by the State Auditor's Office concerning a tax credit within six months of receiving the audit.[9]
2. Includes the Attorney General in a list of people which may receive information regarding an individual taxpayer if the information is pertinent to an Attorney General investigation.[10]
3. The establishment of a system to classify each tax credit in order to verify compliance and instill confidence without causing undue burdens on those applying for the credits.[11]
4. The implementation of reporting requirements for all the tax credits. The reporting requirements vary according to the specific features of each credit.[12]

[9] Section 21.810, RSMo
[10] Section 32.057, RSMo
[11] Section 135.800 and 135.802, RSMo
[12] The taxpayer receiving the tax credit also received the responsibility of the reporting requirements, except in the case of contribution credits in which the reporting was left to the entity distributing the tax credits.

These requirements are intended to provide information to future legislatures so that they have the information to accurately assess the value of each credit. A compliance system is also implemented for these reporting requirements.[13]

5. Adopts a requirement that in order to receive a tax credit, the taxpayer must not owe any delinquent taxes. [14]
6. Requires all departments responsible for administering a tax credit program to employ a tracking system to track each program.[15]
7. Prohibits tax credits for donations to the Missouri Higher Education Scholarship Fund and the Advantage Missouri Program.[16]
8. Makes application information available under the Sunshine Law after the tax credits have been approved.[17]
9. Grants the Department of Economic Development expanded options in developing agreements with tax credit applicants regarding discretionary tax credits. These expanded options are also extended to agreements concerning recapture provisions.[18]
10. Requires the State Auditor to examine all tax credit programs in the state, not just the programs administered by the Department of Economic Development, every four years and report the finding to the Governor, the Legislature, and specifically the Joint Committee on Tax Policy.[19]

[13] Section 135.810, RSMo
[14] Section 135.815, RSMo
[15] Section 135.825, RSMo
[16] Section 173.196 and 173.796, RSMo
[17] Section 610.255 and 620.014, RSMo
[18] Section 620.017, RSMo
[19] Section 620.1300, RSMo

According to Section 620.1300, RSMo, the State Auditor's Office is responsible for examining the effectiveness of all tax credit programs every four years beginning at the date January 1, 2001. A 2005 audit on the Community Development Corporation Tax Credit Program showed the progress that the State Auditor's Office made on these examinations since January 1, 2001.[20]

## Tax Credits Reviewed by the JCTP

Since the enactment of the Tax Credit Accountability Act of the 2004 session, the Joint Committee on Tax Policy has reviewed all three audits concerning tax credits that have been issued by the State Auditor's Office. A brief description of the three tax credit audits are outlined below.

### *Small Business Investment Tax Credit*[21]

The Small Business Investment (SBI) tax credit program started in 1993 and was authorized to issue up to $13 million in tax credits to individuals, partnerships, financial institutions, trusts or corporations making qualified investments in Missouri small businesses. The program issued tax credits valued at 40 percent of the investment amount for investments in Missouri small businesses and 60 percent for qualified small businesses in a distressed community. The legislation established the SBI program to induce private investment into new or growing Missouri small businesses, which would create jobs and investment.

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[20] This page and not the entire audit is included as Appendix E. The full audit report was distributed to the Joint Committee on Tax Policy in January 2006 and is available at the following website: http://auditor.mo.gov/press/2005-55.pdf

[21] A copy of this audit was provided to the committee in January of 2006. For an electronic copy of the audit visit http://auditor.mo.gov/press/2005-54.pdf.

The audit recommended that the General Assembly not increase its cumulative cap which would make the program active again. The Missouri Incentives Review Committee concurred, commenting that the program will not create enough activity to offset the value of the tax credits. The committee did suggest that state resources should be allocated to a new program that provides a better method for seed and venture capital investments in targeted companies.

### *Community Development Corporation Tax Credit*[22]

Initiated in 1994, the Community Development Corporation tax credit was intended to create community development centers which would invest in small businesses, housing, and redevelopment projects. The cumulative cap ($6,000,000) of the tax credit has been exhausted; all of the tax credits available have been authorized, but not yet issued or redeemed.

The audit recommended that the General Assembly should let the program expire citing the program's failure to make a return on the state's investment. The Missouri Incentives Review Committee came to the same conclusion in their report.

### *Examination Fee Tax Credit*[23]

Insurance companies receive a tax credit for reimbursement of a fee that they are charged by the Missouri Department of Insurance. This fee is collected by the Department of Insurance and deposited into the Insurance Examiners Fund. The fund is then used to pay for staff and expenses to conduct the examinations.

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[22] A copy of this audit was provided to the committee in January of 2006. For an electronic copy of the audit, visit http://auditor.mo.gov/press/2005-55.pdf.

[23] A copy of this audit was provided to the committee in May of 2006. For an electronic copy of the audit, visit http://auditor.mo.gov/press/2005-75.pdf. Additional information regarding how other states treat insurance companies' examination fees was requested by the committee. This was provided to the committee in September of 2006 and is included as Appendix C.

Examinations are conducted for two reasons:

1. Financial Examinations- Are used to assess the insurance companies' financial stability
2. Market Conduct Examinations- Reviews insurance companies' compliance with Missouri's insurance laws

Missouri is one of five states that allow insurance companies to receive tax credits for examination costs. Under section 148.400, RSMo, insurance companies can deduct the entire cost of examinations (fees that they pay) from premium taxes paid to the state and deposited into the General Revenue Fund. A state law passed in 2001 allows insurance companies to carry forward these credits for five years. The Auditor's Report recommends that the Department of Insurance seek legislation to either reduce or eliminate the credit. In response, the department said that it would continue to supply information to the General Assembly as required by the Tax Credit Accountability Act-SB 1099.

**Low Income Housing Tax Credit**

The Low Income Housing Tax Credit is a federal program established in the Tax Reform Act of 1986. The intent of the program is to provide low income housing through private development by authorizing credits to private entities in exchange for lower than market rental rates to private citizens. The private entity must comply with the regulations of the program for fifteen years or face recapture of the federal tax credit. Each year the federal government authorizes an amount equal to $1.90 (this amount is adjusted for inflation each year) times its population to each state. The executive

authority, in this case the Missouri Housing Development Commission, is charged with administering the program. Some states, as in the case of Missouri, have a program that is twined with the federal program which provides additional incentives (tax credits) to developers to provide affordable housing in extremely low income areas.

Developers who are awarded both the federal and state tax credit must form a partnership with a syndicator (generally the developer is the managing partner of the project while the syndicator provides the capital for the project as well as receives the great majority of the tax credits). This partnership is then allocated the state and federal tax credits (a tenth of the total value of the tax credits each year over the course of ten years) which are transferable. The syndicator will then sell the tax credits to investors (usually at a price less than the full value of the dollar) in exchange for the immediate equity and partial ownership of the project.

## Testimony before the Committee

In September of 2005, the Joint Committee on Tax Policy heard testimony from a tax credit panel.[24] The comments and recommendations of this panel as well as the suggestions provided in a briefing paper[25] submitted to the committee are outlined below.

### *General Observations*

State tax credit programs have an interplay effect with the Federal tax code. Some state programs, such as the Low Income Housing Tax Credit or the Historic Preservation Tax Credit, are modeled or twinned with a federal program to reduce

[24] The panel consisted of Steven Stogel of DFC Group, Douglas Woodruff of Bank of America, and Linda Martinez of Bryan Cave, LLP.
[25] The briefing paper was submitted by one of the members of the panel, Steve Stogel of DFC Group.

administrative compliance costs as well as to leverage more capital to Missouri by attracting investors with incentives at the state level.[26]

Missouri's tax credits should adopt standard features including a broad and universal definition of taxpayer, especially to include public and private foundations as well as standard carry-back and carry-forward provisions. The standardization of these tax credit features as well as uniformity in the transferability and "certification" of tax credits were echoed by the Missouri Incentives Review Committee in their report. The report also discussed developing uniformity among the following definitions in relation to tax credits: new jobs, new private investment, project facility, related company, base employment, and eligible company. In addition, the Missouri Incentives Review Committee recommended developing uniform and consistent procedures as well as implementing electronic applications to ease compliance and increase accuracy.[27]

State credits generally "reduce" and not "pay" state tax liability.[28] Consequentially, the deduction for state taxes paid for non-AMT taxpayers is lost if state tax credits are used. For AMT taxpayers, the deduction for state taxes paid is eliminated in the AMT calculation.

Missouri should review all tax credit programs that have a refundable provision. These programs are included in the total states revenues (TSR) and therefore fall under

[26] For instance, investors would more likely invest in a project in a state which has a program that mirrors the federal program because the monetary incentive to invest in the project would be greater.
[27] Missouri Incentives Review Committee Report, page 16.
[28] IRS chief Counsel Memorandum 200445046 responded to a Massachusetts inquiry which asked for clarification regarding whether tax credits either pay or reduce state tax liability. The memo cited that tax credits which are transferable are considered an exchange of property and therefore are considered a payment of taxes and not a reduction of taxes paid. The memo is included as Appendix D.

the Hancock law umbrella. The tax credits that are not refundable may not be included in calculating total state revenues.[29]

Any reform of the tax credit laws especially concerning the effective date and transition rules should be "carefully articulated."

Missouri should consider incorporating its own version of the Alternative Minimum Tax under the theory that "everyone should pay something."

Missouri should also consider establishing a process to review how many tax credits/incentive programs can be aggregated to be utilized for one project or for one particular organization.

Missouri should look into having all of its tax credits being evidenced by a certificate.

In addition, extending the reporting requirements for how the tax credit is actually used may be one method to increase accountability, effectiveness, and the information used in determining who should be awarded the discretionary credits in future years.

***Contribution Credits***

Changing the ratio from 2:1 to 3:1 (for every two dollars of donation, one dollar of credit or 50% to for every three dollars of donation, one dollar of credit or 33% respectively) would result in savings of $16,667,000 annually, especially if Missouri expanded its definition of taxpayer to include public and private foundations. This change in the ratio of the amount of tax credits awarded would not deter contributions. A uniform change applied to all tax credits would be the ideal.

[29] *Missouri Merchants and Manufacturers Association, et al. v. State of Missouri and Francis E. Flotron, et al. v. Bob Holden, Governor, et al. 2001.*

Additionally, for information purposes, if appreciated securities are used for the donation, the net cost of the taxpayer is reduced as the federal internal revenue code allows for a deduction on the total amount of charitable donations as well as disallows any capital gain collection. Should the appreciation reach six dollars to an initial one dollar basis, then the net cost of the donation to the taxpayer drops below zero and becomes positive.

***Low Income Housing Tax Credit***

To improve the pricing of the state tax credit, Missouri should consider reforming the current state Low Income Housing Tax Credit by switching to a transferable certificate program rather than an allocation program. This change would expand the limited number of buyers of the allocated credits to a much larger pool of buyers interested in a transferable certificate. Also, Missouri should consider eliminating the recapture provision of the state tax credit.

The logic of this change is to improve the pricing (the amount that the credit sells for in the marketplace) of the credit which for the state credit has ranged from 25-45 cents for every dollar of state credit. Making the state tax credit a transferable certificate drops the bank financing rate of 15% or greater to a bank financing rate of 6-7%, therefore improving the pricing of the credit. The elimination of the recapture provision would also increase the pricing of the credit. The theory is that the recapture provision on the federal credit is too great of a "hammer" to cause the partnership to falter on the obligations of the program; since the obligations of the state program are the same as the federal program, the benefits of the increased credit pricing while still taking advantage of the "hammer" associated with the federal recapture provision are too great to ignore.

Generally, these credits have been treated as a reduction of income taxes owed rather than a payment of income taxes. This has important implications for the federal tax code. A reduction in state income taxes paid means that the taxpayer does not get to deduct the value of the credit, only the remaining state income tax liability after the tax credit is applied. This reduces the value of the credit for the highest bracket taxpayers by 35% for a non-AMT corporation, 36% for a non-AMT taxpayer, and 28% for AMT[30] taxpayers for every dollar of state tax credit. Some of this "interplay" with the federal tax code is already at work which has led to an increase in the pricing of the credits in recent years.

Additionally, MHDC can cut by 40% the amount of money to be awarded for the state tax credit program and still leverage the same amount of money as the pre-Massachusetts ruling, 25 cents per $1 of credit. This administrative change would allow savings exceeding $7,000,000 in year one, $14,000,000 in year two, $21,000,000 in year three, etc. Should the legislative changes discussed earlier be enacted, the savings would be even greater.[31] However, should this 40% cut in funding be implemented, MHDC should still retain the ability to match the federal credit at 100% in order to assist special housing needs or rural or urban areas with extremely low median incomes.

[30] AMT taxpayers are not allowed the deduction for state taxes paid when calculating their AMT liability; however, the tax liability stemming from the AMT is a credit against the federal income taxes owed in future tax years when the AMT does not cause an increase in tax liability compared to the tax liability calculated under normal circumstances.

[31] The legislative changes discussed earlier (changing the structure of the credit from an allocation credit to a transferable certificate and eliminating the recapture provision) is projected by Steve Stogel to cause the pricing of the credit to increase to between 55 and 65 cents per $1 of credit and an additional projected savings of $89,000,000 over a seven year period should all of these changes be enacted simultaneously.

| | B | C | D | E | F | G | H | I | J | K | L | M | N | O | Q |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1 | Name | Authorization, RSMo. | Transferab | Refundable | arry Forwar | Carry Back | Multi Year | Fed Ded | Cap Type | Cap Amount | Authorized | Issued | Redeemed | Total Outstanding | Agency |
| 2 | Bond Enhancement/Bond Guarantee | 100.297 | yes | no | 10 | 0 | | no | cumulative | 50,000,000 | 870,275 | 870,275 | 594,034 | 276,241 | DED |
| 3 | New and Expanded Business Facility Credit | 135.100 to 135.150, 135.258 | yes | yes | 10 | 0 | | no | none | | 8,779,797 | 8,779,797 | 4,546,330 | 3,085,774 | DED |
| 4 | Brownfield "Jobs and Investment" | 447.700 to 447.718 | no | at DED des | 0 | 0 | | no | none | | 406,273 | 1,646,927 | 1,726,687 | 0 | DED |
| 5 | Commuity Development Corporation | 135.400 to 135.430 | yes | no | 10 | 0 | | no | cumulative | 6,000,000 | 0 | 0 | 2,021,628 | 1,250,000 | DED |
| 6 | Development Tax Credit | 32.110 to 32.125 | yes | no | 5 | 0 | | no | annual | 6,000,000 | 5,591,000 | 2,866,000 | 2,487,152 | 6,762,264 | DED |
| 7 | Brownfield (Demolition) | 447.700 to 447.718 | no | no | 20 | 0 | | no | none | | 0 | 0 | 0 | 0 | DED |
| 8 | Dry Fire Hydrant | 320.093 | yes | no | 7 | 0 | | no | annual | 500,000 | 0 | 0 | 17,228 | 65,000 | DED |
| 9 | Enterprise Zone | 135.200 to 135.270, 135.429 | no | yes (EZR) | 0 | 0 | | no | none | | 39,066,023 | 39,066,023 | 25,294,754 | 0 | DED |
| 10 | Family Development Account | 208.750 to 208.775 | no | no | 0 | 0 | | no | annual | 4,000,000 | 780,000 | 7,625 | 12,875 | 4,000 | DED |
| 11 | Film Production | 135.750 | yes | no | 5 | 0 | | no | annual | 1,500,000 | 1,500,000 | 0 | 322,079 | 752,705 | DED |
| 12 | Historic Preservation TCP | 253.545 to 253.561 | yes | no | 10 | 3 | | yes | none | | 116,566,180 | 80,213,374 | 74,532,355 | 61,343,552 | DED |
| 13 | Small Business Investment/Capital | 135.400 to 135.429 | yes | no | 10 | 3 | | no | cumulative | 13,000,000 | 0 | 0 | 109,050 | 969,475 | DED |
| 14 | Missouri Quality Jobs | 620.1875 to 620.1890 | yes | yes | 0 | 0 | | no | annual | 12,000,000 | 0 | 0 | 0 | 0 | DED |
| 15 | Neighborhood Assistance | 32.100 to 32.125 | no | no | 5 | 0 | | no | annual | 18,000,000 | 16,000,000 | 11,263,385 | 9,286,880 | 14,000,000 | DED |
| 16 | New Enhanced Enterprise Zone | 135.1050 to 135.1075 | yes | yes | 0 | 0 | | no | annual | 4,000,000 | 0 | 0 | 0 | 0 | DED |
| 17 | New Enterprise Creation | 620.635 to 620.653 | yes | no | 10 | 0 | | no | cumulative | 20,000,000 | 0 | 4,212,752 | 2,504,561 | 7,155,490 | DED |
| 18 | Rebuilding Communities | 135.535 | yes | no | 5 | 3 | | no | annual | 8,000,000 | 6,970,463 | 1,736,701 | 1,694,006 | 1,955,245 | DED |
| 19 | Neighborhood Preservation Tax Credit | 135.475 to 135.487 | yes | no | 5 | 3 | | no | annual | 16,000,000 | 13,609,190 | 6,784,310 | 8,641,503 | 6,824,880 | DED |
| 20 | Qualified Research Expence/Research | 620.1039 | no | no | 5 | 0 | | no | annual | 10,000,000 | 0 | 0 | 1,626,864 | 5,823,761 | DED |
| 21 | Brownfield Redevelopment Program (Remediation) | 447.700 to 447.718 | yes | no | 20 | 0 | | no | none | | 15,515,319 | 14,808,297 | 10,627,870 | 4,180,427 | DED |
| 22 | Small Business Incubator | 620.495 | yes | no | 5 | 0 | | no | annual | 500,000 | 500,000 | 361,913 | 246,807 | 384,983 | DED |
| 23 | Small Business Guaranty Fees/Loan Guarentee Fee | 135.766 | no | no | 0 | 0 | | no | none | | 103,591 | 103,591 | 11,224 | 0 | DED |
| 24 | Mo. Business Modernization and Technology (seed k) | 348.300 to 348.318 | yes | no | 10 | 0 | | no | cumulative | 9,000,000 | 0 | 0 | 164,894 | 337,341 | DED |
| 25 | Transportation Development | 135.545 | yes | no | 10 | 3 | | no | annual | 10,000,000 | 6,682,249 | 3,226,568 | 3,545,219 | 7,000,000 | DED |
| 26 | Wine and Grape Production | 135.700 | no | no | 0 | 0 | | no | none | | 313,683 | 313,683 | 179,323 | 0 | DED |
| 27 | Youth Oppertunities | 135.460 and 620.1100 to 620.1103 | no | no | 5 | 0 | | no | annual | 6,000,000 | 6,438,159 | 4,476,005 | 3,211,185 | 5,000,000 | DED |
| 28 | Skills Development Credit | N/A | yes | no | 5 | 0 | | n/a | annual | 6,000,000 | 0 | 0 | 0 | 0 | DED |
| 29 | Certified Capital Companies (CAPCO) Program | 135.500 to 135.529 | yes | no | until used | 0 | | none | 10 year cumulative | | 14,000,000 | 14,000,000 | 13,429,309 | 45,440,744 | DED |
| 30 | BUILD Missouri | 100.700 to 100.850 | no | yes | 0 | 0 | | no | annual | 15,000,000 | 7,842,167 | 8,419,707 | 3,770,557 | 4,649,150 | MDFB |
| 31 | Development Reserve | 100.25 | yes | no | 5 | 0 | | no | none | none | 0 | 0 | 0 | 0 | MDFB |
| 32 | Export Finance | 100.25 | yes | no | 5 | 0 | | no | none | none | 0 | 0 | 0 | 0 | MDFB |
| 33 | Infrastructure TCP | 100.286(6) | yes | no | 5 | 0 | | no | annual, flex | 10,000,000 | 10,398,000 | 28,964,274 | 25,953,799 | 37,308,093 | MDFB |
| 34 | Affordable Housing Assistance TCP | 32.105 to 32.125 | yes | no | 10 | 0 | | yes | annual | 11,000,000 | 11,000,000 | 9,133,829 | 7,702,860 | 15,000,000 | MHDC |
| 35 | Mo. Low Income Housing | 135.350 to 135.363 | yes | no | 5 | 3 | 10 | yes | annual (100% of federal LI | | 183,106,160 | 83,477,412 | 65,392,601 | 156,095,405 | MHDC |
| 36 | Special Needs Adoption | 135.325 | yes | no | 4 | 0 | | yes | annual | 4,000,000 | N/A | N/A | 2,578,354 | N/A | DOR |
| 37 | Bank Franchise Tax | 148.064 | no | x | 0 | x | x | no | none | | N/A | N/A | 2,543,523 | 0 | DOR |
| 38 | Bank Tax Credit for S Corp. Sharehoders | 143.471 | yes | no | 4 | 0 | | no | none | | N/A | N/A | 941,460 | N/A | DOR |
| 39 | Cellulose Casings | 260.285 | no | no | 0 | 0 | | no | appropriation | | N/A | N/A | 382,540 | 0 | DOR |
| 40 | Disabled Access | 135.490 | no | no | unlimited | 0 | | yes | none | | N/A | N/A | 56,761 | N/A | DOR |
| 41 | Agricutural Product Utilization Contributor | 348.430 | yes | no | 5 | 3 | | no | annual | 6,000,000 | 6,000,000 | 2,081,343 | 1,639,540 | 4,593,008 | MASBDA |
| 42 | New Generation Cooperative Incentive | 348.430 | yes | no | 5 | 3 | | no | annual | 6,000,000 | 6,000,000 | 3,915,000 | 3,334,935 | 6,749,210 | MASBDA |
| 43 | Charcoal Producers | 135.313 | yes | no | 7 | 0 | | n/a | none | 0 | 146,606 | 146,606 | 70,151 | 575,597 | MASBDA |
| 44 | Processed Wood Energy | 135.300 | yes | no | 4 | 0 | | no | none | | 3,348,890 | N/A | 3,700,285 | N/A | DNR |
| 45 | Maternity Home | 135.600 | no | no | 4 | 0 | | n/a | annual | 2,000,000 | 953,987 | 935,987 | 743,635 | N/A | DSS |
| 46 | Shelter for Victims of Domestic Viloence | 135.550 | no | no | 4 | 0 | | none | annual | 2,000,000 | 2,000,000 | 648,618 | 515,034 | 1,251,032 | DPS |
| 47 | Sponsorship and Mentoring Program | 135.348 | no | no | 4 | 0 | | none | appropriati | 0 | 0 | 0 | 0 | 0 | DESE |
| 48 | Shared Care | 660.055 | no | no | 0 | 0 | | n/a | none | | 854,443 | | | 0 | DHSS |
| 49 | Examination Fee Tax Credits(exam) | 148.400 | no | no | 5 | 0 | | none | total of pool | | 7,576,530 | 7,576,530 | 2,650,135 | 5,703,974 | DOI |
| 50 | Examination Fee Tax Credits(valuation) | 148.400 | no | no | 0 | 0 | | none | total of pool | | 35,000 | 35,000 | 12,000 | 23,000 | DOI |
| 51 | Examination Fee Tax Credits(registratoin) | 148.400 | no | no | 0 | 0 | | none | total of pool | | 24,430 | 24,430 | 24,430 | 0 | DOI |
| 52 | Mo. Life and Health Guaranty Assoc. | 376.745 | no | no | no | no | 5 | none | total of pool | | 0 | 0 | 0 | 0 | DOI |
| 53 | Mo. Property and Casualty Guaranty Assoc. | 375.774 | no | no | no | no | 3 | none | total of pool | | 7,227,710 | 7,227,710 | 5,965,556 | 1,998,707 | DOI |
| 54 | Mo. Health Insurance Pool | 376.975 | no | no | until used(e | no | | none | total of pool | | 10,015,203 | 10,015,203 | 6,121,053 | 9,066,945 | DOI |

# Introduction

Through its expenditures, a government is given command over resources that otherwise would have been under the command of the private sector. Government purchases are financed principally through taxation; that is, the collection of resources from the private sector to finance its purchases. Both tax collections and government expenditures are recorded and are therefore, referred to as "on-budget" items.

In addition to the on-budget, or direct effects, governments implement taxes that alter prices. Accordingly, taxes have distortionary effects: the taxes create incentives for people to allocate resources differently than they would under a tax code with no distortionary taxes. The distortionary effects result in a different composition of goods being purchased and in a different distribution of income. The size of the distortionary effects depends on the tax code itself. Unlike expenditures, however, distortionary effects are not recorded as on-budget outlays. Thus, the distortionary effects are referred to as "off-budget" items.

Despite the apparent differences between on-budget and off-budget items, there are some important similarities. Most importantly, both on-budget and off-budget items ultimately influence the resources used by the private sector. The similarity suggests that some treatment of off-budget items is warranted, including how they are measured.

The purpose of this report is to provide estimates of the tax expenditures. Broadly defined, a tax expenditure is a tax revenue that the government foregoes by means of preferential provisions in the tax code. More specifically, tax codes have special provisions—namely, exclusions, exemptions, deductions, credits, and preferential tax rates—that affect people's resource allocations and the distribution of income. Government revenue losses caused by these special provisions are referred to as tax expenditures. Compared to direct government outlays, special provisions free (read, effectively lower) taxes and thus, allocate resources that would have otherwise been under the government's control.

There is some subjectivity in terms of identifying what is a tax expenditure and what is not. Governments choose parameters of the tax code; in particular, these provisions are exclusions, deductions, credits, deferrals, and preferential tax rates. Within this class of government tax provisions, one can take a narrow or a broad view of what constitutes a tax expenditure. Under the narrow view, a tax expenditure is reserved for changes in tax code that are close substitutes for direct government spending. Under a broader view, the notion of substitutability is not restricted to some notion of closeness. For example, to preserve historic buildings, the government can purchase the buildings and thereby ensure their upkeep. Alternatively, the government could issue tax credits to citizens willing to maintain the historic structures. In both cases, historic buildings are preserved. Thus, the credit and purchase achieve the same goal and are viewed as being close substitutes. Clearly, the sense of what is a close substitute is subjective.

In order to determine what constitutes a tax preference, it is first necessary to establish a point of reference. Generally speaking, there are two methods available: (i) the base-year (also known as the reference-law) method involves a comparison of the current tax code to that which existed in some pre-determined base year; and (ii) a comparison of current tax code to some theoretical norm. Both methods are utilized here. Under both methodologies, the resulting tax expenditure measure is an index number. In cases in which the base-year method is utilized, we will follow the same base year utilized in the calculation of Federal tax expenditures; that is, we will use the tax code in 1974 as the base year. To illustrate, suppose tax credits for historic building preservation are set at \$100 million in 1974. If the tax-credit ceiling is raised to \$150 million, and redeemed, in 1975, then there would be a tax expenditure equal to \$50 million in 1975.

Judgments are also applied in choosing which method to use. In particular, judgment is used to determine whether a particular tax provision constitutes preferential treatment or not. For instance, the treatment of depreciation allowances for machinery and equipment illustrates the differences in tax-expenditure treatments under the two alternative methods. Prior to the most recent changes in accelerated depreciation allowances, an analysis using the base-year, or reference-law method, would compute that there was no tax expenditure for depreciation allowances. Before 2000, the current accelerated depreciation rules were much the same as in the base-year (1974) codes. Under the theoretical norm baseline, however, accelerated depreciation allowances constitute a tax expenditure. The intuition behind this tax expenditure is straightforward. Under an accelerated depreciation schedule, business expenses are higher, profits are lower, and the corporation's tax bill is reduced. Suppose, instead, that depreciation expenses were taken over the theoretical norm. Insofar as the theoretical norm is the economic life of the asset, depreciation expenses would be spread over a longer time period, resulting in

higher profits and taxes. Thus, compared to the useful life of the machinery and equipment, an accelerated depreciation allowance is a preferential treatment.[1] The difference between the year 2000 federal tax expenditure under the reference-law and theoretical norm baseline is estimated to be about $31 billion.

Under Missouri statutes, determination of what constitutes a tax expenditure is even more difficult.[2] In part, the difficulty owes to Missouri's definition of income, statutory adjustments, and itemized deductions. Because Missouri has adopted the Federal definitions, preferential tax treatment enacted at the federal level implicitly results in preferential tax treatment at the state level. In addition, Missouri adopts its own preferential tax treatments, especially in the form of pension income, special itemized deductions for social security and railroad retirement taxes paid along with a plethora of income tax credits.

## Policy Implications

Tax expenditures serve two principal purposes. First, they redistribute the tax burden. Personal tax exemptions and sales tax exemptions for food and prescription drugs, for instance, shift the tax burden from lower income tax reporting units to higher income tax reporting units. In other words, the overall tax code becomes more progressive.

Second, tax expenditures provide incentives. These incentives encourage activities or behaviors that society deems are worthy. The HOPE credit for college fees, and charitable deductions are examples of tax expenditures aimed at encouraging college enrollment and donations to identified charitable organizations, respectively.

In many instances, a direct government outlay is more apparent than a tax expenditure. Through direct appropriation, the government acquires the resource directly in order to provide a public good, such as national defense or highways; as such, the government acquires goods for public consumption. In contrast, a tax expenditure achieves public goals, such as a more politically acceptable distribution of income or encouraging specific types of quasi-public goods (e.g., a better educated society), through actions undertaken by private agents.

Because direct appropriations are more often easier to observe, there may be a bias to implementing policies through direct outlays as opposed to preferential tax treatment as a way to achieve public goals. It is not that tax expenditures are not recognized as means to achieve public goals. But, the level of achievement depends on a very complex set of interactions between people. For instance, it is difficult to measure the economic impact because it requires thorough knowledge of how citizens will alter their behavior in response to preferential tax treatments. When considering direct outlays versus a tax expenditure, the policymaker must make some forecast of the economic impact of each policy. Arguably, it is more difficult to forecast the effect of a preferential change in tax code. For one thing, such forecasts rely on our understanding of people's behavior. This task is even more daunting when one considers that preferential tax treatments do not exist in isolation. Perhaps implementing one preferential tax treatment will have ramifications for other taxes that induce people to engage in unexpected behaviors. One simple tax code change can have unforeseen, and undesirable, consequences when implemented.

Such predictive problems notwithstanding, there is value of measuring tax expenditures. Armed with such estimates, policymakers are better prepared to rank alternative policy goals and the means available to achieve these goals. The policymaker's principle job is to identify the lowest cost means of achieving social goals. The policymaker's job becomes substantially more difficult by constraining the policy options to direct appropriations. Thus, measuring tax expenditures provides information that the policymaker can use.



## Overview

This report is divided into seven sections, one for each of the major revenue categories for the State of Missouri. In order, we will detail tax expenditures for the following categories: individual income, corporation income, sales and use, selected excise, corporation franchise, inheritance and estate, and insurance premium.

For this overview to be complete, we identify two caveats that are necessary for the reader to properly interpret the estimates reported here. First, we assume that tax expenditures are independent. More specifically, the independence assumption amounts to estimating one preferential tax treatment at a time. In doing so, we implicitly estimate a tax expenditure as if one tax treatment does not affect the estimates of any other preferential tax treatment. In short, tax expenditures are reported as if they are isolated events. We make this assumption for tractability; without the independence assumption, we would need a model that builds all these interactions into it. No such model exists.

Second, the sum across tax expenditure categories cannot be accumulated and interpreted as the sum of

all preferential tax treatments. In part, the sum suffers from the caveat raised by the independence assumption. In addition, we have noted that tax-expenditure estimates are obtained from reference-law and norm-baseline methods. By adding the estimates from two different methods, one would obtain an amalgam index value that neither represents the value of taxes freed relative to some reference-law tax code nor represents the value of taxes freed relative to some theoretical norm baseline. Indeed, a mixed interpretation is necessary and quite cumbersome. We also note that even with the set of tax-expenditures estimates using the reference-law method, the State of Missouri and the Federal calculations do not necessarily use the same base year. We do not provide a summary table of all tax expenditures and strongly recommend that readers do not accumulate across tax-expenditure categories.

Such caveats notwithstanding, we proceed with our reporting of the estimates of tax expenditures, beginning with those preferential tax treatments directed toward individual income tax codes.



[1] The accelerated depreciation schedule is an excellent way to illustrate how the theoretical norm baseline is applied to the calculation of a tax expenditure.

[2] In general we adopt the broad federal definition. As such, a tax expenditure consists of all exemptions, deductions, credits, and preferential tax rates as defined in the Tax Expenditure Report issued by the Office of Management and Budget.

## Exhibit 1
## Summary of Tax Expenditures
## 1998-2008

| | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004F | 2005F | 2006F | 2007F | 2008F |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Individual Income Tax** | | | | | | | | | | | |
| Exclusions | | | | | | | | | | | |
| Missouri | 14.9 | 19.4 | 30.7 | 37.1 | 38.9 | 37.7 | 37.8 | 38.1 | 37.8 | 37.2 | 36.3 |
| Federal | 1,064.6 | 1,120.6 | 1,133.3 | 1,270.8 | 1,398.9 | 1,508.4 | 1,618.3 | 1,709.5 | 1,793.7 | 1,851.6 | 1915.7 |
| Deductions | | | | | | | | | | | |
| Missouri | 2,247.0 | 2,447.8 | 3,242.4 | 3,284.0 | 3,251.4 | 3,244.5 | 3,332.6 | 3,427.5 | 3,541.8 | 3,641.2 | 3,768.9 |
| Federal | ¤ | ¤ | ¤ | ¤ | ¤ | ¤ | ¤ | ¤ | ¤ | ¤ | ¤ |
| Missouri Credits | 98.0 | 209.7 | 223.6 | 187.7 | 146.2 | 168.9 | 199.6 | 197.6 | 196.4 | 196.5 | 196.8 |
| **Corporation Income Tax** | | | | | | | | | | | |
| Exclusions | | | | | | | | | | | |
| Missouri | ¤ | ¤ | ¤ | ¤ | ¤ | ¤ | ¤ | ¤ | ¤ | ¤ | ¤ |
| Federal | 44.0 | 44.5 | 36.5 | 63.2 | 65.4 | 67.5 | 69.5 | 71.8 | 74.2 | 76.4 | 78.8 |
| Deductions | | | | | | | | | | | |
| Missouri | 47.0 | 40.0 | 65.7 | 52.9 | 63.9 | NA | NA | NA | NA | NA | NA |
| Federal | 227.3 | 292.9 | 268.9 | 505.6 | 396.7 | 316.7 | -86.3 | -55.5 | -49.7 | -48.7 | -45.9 |
| Missouri Credits | 49.7 | 30.5 | 38.0 | 20.8 | 18.4 | 57.5 | 70.1 | 69.9 | 70.0 | 70.8 | 72.2 |
| **Sales and Use Tax** | | | | | | | | | | | |
| Exempt Sales | NA | NA | NA | NA | NA | NA | NA | NA | NA | NA | NA |
| Personal | 1,482.8 | 1,543.5 | 1,645.0 | 1,666.5 | 1,696.4 | 1,755.7 | 1,799.4 | 1,843.2 | 1,887.1 | 1,931.2 | 1975.5 |
| Business | NA | NA | NA | NA | NA | NA | NA | NA | NA | NA | NA |
| Missouri Credits | 29.4 | 31.1 | 32.9 | 30.9 | 31.3 | 32.3 | 33.0 | 33.7 | 34.4 | 35.1 | 35.8 |
| **Corporation Franchise Tax** | | | | | | | | | | | |
| Missouri Credits | 5.2 | 3.6 | 2.9 | 3.3 | 2.0 | 2.5 | 4.9 | 5.4 | 6.1 | 7.1 | 8.6 |
| **Insurance Premium Taxes** | | | | | | | | | | | |
| Exclusions | 37.2 | 39.2 | 37.8 | 79.8 | 92.7 | 93.4 | 104.5 | 115.6 | 126.7 | 137.8 | 148.9 |
| Missouri Credits | 32.2 | 45.9 | 48.2 | 50.8 | 62.8 | 67.7 | 73.7 | 79.2 | 85.4 | 92.3 | 100.1 |
| **Selected Excise Taxes** | | | | | | | | | | | |
| Missouri Credits | | | | | | | | | | | |
| Cigarette | 3.3 | 3.2 | 3.1 | 3.1 | 3.0 | 3.0 | 2.9 | 2.9 | 2.8 | 2.8 | 2.7 |

*Figures in millions of dollars; NA = Not available; ¤ = Not applicable; F = Forecasted numbers*

# Exhibit 2
## Summary of Major Provisions of Missouri Tax Credits

| Credit | RSMO | Effective Year: Income Tax: Individual | Effective Year: Income Tax: Corp. | Effective Year: Corp. Franchise | Effective Year: Financial Institution | Effective Year: Insurance Premium | Carry Forward | Transfer or Sold | Refund-able |
|---|---|---|---|---|---|---|---|---|---|
| Senior Citizen Property Tax | 135.010 | 1975 | ¤ | ¤ | ¤ | ¤ | None | No | Yes |
| Neighborhood Assistance | 32.100 | 1978 | 1978 | 1978 | 1978 | 1978 | 5 Years | No | No |
| New or Expanded Business Facility | 135.100 | 1980 | 1980 | ¤ | 1980 | 1980 | None | Yes | Yes |
| Development Reserve | 100.250 | 1982 | 1982 | 1982 | ¤ | ¤ | 5 Years | Yes | No |
| Enterprise Zone | 135.200 | 1982 | 1982 | 1982 | 1982 | 1982 | None | No | Yes |
| Export Finance | 100.250 | 1982 | 1982 | 1982 | 1982 | 1982 | 5 Years | Yes | No |
| Infrastructure Development | 100.250 | 1982 | 1982 | 1982 | 1982 | 1982 | 5 Years | Yes | No |
| Seed Capital | 348.300 | 1986 | 1986 | 1986 | 1986 | NA | 9 Years | Yes | No |
| Wood Energy Producers | 135.300 | 1986 | 1986 | ¤ | ¤ | ¤ | 4 Years | Yes | No |
| New Jobs Training | 178.894 | 1988 | ¤ | ¤ | ¤ | ¤ | None | No | No |
| Special Needs Adoption | 135.325 | 1988 | 1988 | ¤ | ¤ | ¤ | 4 Years | Yes | No |
| Small Business Incubator | 620.495 | 1989 | 1989 | 1989 | 1989 | ¤ | 5 Years | Yes | No |
| Affordable Housing | 32.111 | 1990 | 1990 | 1990 | 1990 | 1990 | 10 Years | No | No |
| Low Income Housing | 135.350 | 1991 | 1991 | 1991 | 1991 | 1991 | 5 Years, Back 3 | Yes | No |
| Community Bank Investment | 135.400 | 1993 | 1993 | 1993 | 1993 | ¤ | 9 Years | Yes | No |
| Qualified Research Expense | 620.1039 | 1993 | 1993 | ¤ | ¤ | 1997 | 5 Years | No | No |
| Small Business Investment | 135.400 | 1993 | 1993 | 1993 | 1993 | 1993 | 9 Years | Yes | No |
| Higher Education Scholarship | 173.196 | 1995 | 1995 | 1995 | 1995 | 1995 | 5 Years | No | Yes |
| Youth Opportunities | 135.460 | 1996 | 1996 | ¤ | ¤ | ¤ | 5 Years | No | No |
| Business Use Incentives (BUILD) | 100.700 | 1997 | 1997 | ¤ | 1997 | 1997 | None | No | Yes |
| Brownfield Tax Benefits | 447.700 | 1997 | 1997 | 1997 | 1997 | 1997 | 20 Years | Yes | No |
| CAPCO Investments | 135.500 | ¤ | ¤ | ¤ | ¤ | 1997 | Indefinitely | Yes | No |
| Charcoal Producers | 135.313 | 1998 | 1998 | ¤ | ¤ | ¤ | 7 Years | Yes | No |
| Historic Preservation | 253.545 | 1998 | 1998 | 1998 | 1998 | 1998 | 10 Years, Back 3 | Yes | No |
| Maternity Home | 135.600 | 1998 | 1998 | 1998 | 1998 | 1998 | 4 Years | No | No |
| Shelter for Victims of Domestic Violence | 135.550 | 1998 | 1998 | 1998 | 1998 | 1998 | 4 Years | No | No |
| Sponsorship & Mentoring | 135.348 | 1998 | 1998 | ¤ | ¤ | ¤ | 4 Years | No | No |
| Film Production | 135.750 | 1999 | 1999 | ¤ | 1999 | 1999 | 10 Periods, 5 Total | Yes | No |
| Skills Development | 620.1400 | 1999 | 1999 | ¤ | 1999 | 1999 | 5 Years | Yes | No |
| Wine & Grape Production | 135.700 | 1999 | 1999 | ¤ | ¤ | ¤ | None | No | No |
| Rebuilding Communities | 135.535 | 1999 | 1999 | 1999 | 1999 | 1999 | 5 Years, Back 3 | Yes | No |
| Transportation Development | 135.545 | 1999 | 1999 | 1999 | 1999 | 1999 | 10 Years, Back 3 | Yes | No |
| Advantage Missouri Program | 173.775 | 1999 | 1999 | ¤ | ¤ | ¤ | 10 Years | No | No |
| Agricultural Product Utilization Contributor | 348.430 | 1999 | 1999 | 1999 | 1999 | ¤ | 5 Years | Yes | No |
| Bank Tax Credit for S Corp. Shareholders | 143.471 | 1999 | 1999 | 1999 | 1999 | ¤ | 5 Years | No | No |

¤ = *Not applicable*

# Exhibit 2 (continued)
## Summary of Major Provisions of Missouri Tax Credits

| | | Effective Year | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | Income Tax | | Corp. | Financial | Insurance | | Transfer | Refund- |
| Credit | RSMO | Individual | Corp. | Franchise | Institution | Premium | Carry Forward | or Sold | able |
| Dry Fire Hydrant | 320.093 | 1999 | 1999 | ¤ | 1999 | 1999 | 7 Years | Yes | No |
| Family Development Account | 208.750 | 1999 | 1999 | ¤ | ¤ | ¤ | None | Yes | No |
| New Enterprise Creation | 620.635 | 1999 | 1999 | 1999 | 1999 | 1999 | 10 Years | Yes | No |
| New Generation Cooperative Incentive | 348.432 | 1999 | 1999 | 1999 | 1999 | ¤ | 5 Years, Back 3 | Yes | No |
| Remediation Tax Credit | 447.708 | 1999 | 1999 | 1999 | 1999 | 1999 | 15 Years | Yes | No |
| | | | | | | | | | |
| SBA Guaranty Fee | 144.605 | 1999 | 1999 | ¤ | ¤ | ¤ | None | Yes | No |
| Pharmaceutical Tax | 135.095 | 1999 | ¤ | ¤ | ¤ | ¤ | 6 Years | No | No |
| Shared Care | 660.053 | 2000 | 2000 | ¤ | ¤ | ¤ | None | No | No |
| Disabled Access | 135.490 | 2000 | 2000 | ¤ | ¤ | ¤ | No Limit | No | No |
| Mature Worker Child Care | 620.1560 | 2000 | 2000 | 2000 | 2000 | 2000 | None | Yes | No |
| | | | | | | | | | |
| Strategic Initiative Investment Income | 135.270 | 1998 | 1998 | ¤ | ¤ | ¤ | None | No | Yes |
| Neighborhood Preservation | 135.475 | 2000 | 2000 | 2000 | 2000 | 2000 | 5 Years, Back 3 | Yes | No |
| Bank Franchise | 148.064 | 2001 | 2001 | ¤ | 2001 | 2001 | None | No | No |
| Demolition Tax | 447.700-447.718 | 2000 | 2000 | 2000 | 2000 | ¤ | 20 years | No | No |
| Development Tax Credit | 32.100-32.125 | 2002 | 2002 | 2002 | 2002 | 2002 | 5 Years | Yes | No |

¤ = *Not applicable*

MISSOURI DEPARTMENT OF INSURANCE

Comparison of Insurance Company Examination Funding/Credit in the U.S.

| STATE | FINANCIAL and MARKET CONDUCT EXAMINATION FUNDING | EXAM CREDIT? | TAX RATE |
|---|---|---|---|
| Alabama | Charges the companies examined for the expenses of examination including actuarial and other consultants. | Yes | Variable |
| Alaska | Insurance companies pay directly for examinations. | No | 2.7% |
| Arizona | Examinations are funded by billings to the examinee. | No | 2% |
| Arkansas | Examiner’s salaries and all examination expenses (lodging meals, and travel) are paid by the company being examined. When the department requires the services of outside contract professional to assist or carryout an examination the contractor sends his/her billing to the department for approval who then sends it to the company for payment directly to the contractor. | No | 2.5% |
| California | Examinations are at the expense of the insurer, organization or person being examined | No | 2.35% |
| Colorado | Use independent contract examiners to perform market conduct exams. The reasonable expenses and charges of the independent contractors shall be paid directly to the contractors by the examinee. There is an additional provision that the reasonable expenses of a market conduct exam shall not include the compensation of the commissioner and his assistants, and that domestic companies should be examined by the commissioner and his assistants (employee examiners) unless there is good cause to use contract examiners. | No | 2% |
| Connecticut | | | 1.75% |
| Delaware | | | 1.75% |
| Florida | | | 1.75% |
| Georgia | Use contract examination firms for all examinations. The companies being examined pay the contractors directly for any invoices approved by the department. All examination invoices are reviewed and approved by the department before they are sent to the respective company. | No | 2.25% |
| Hawaii | Use contractors to perform examinations of insurance companies. Insurance companies reimburse the state for examination costs. | No | 4.265% |
| Idaho | All insurers pay an annual continuation fee and that fee is used to fund examinations. | No | 2.3% |
| Illinois | All domestic, foreign and alien insurance companies pay a yearly financial regulation fee to do business in Illinois. This yearly assessment pays for examiner salaries, operating and administrative expenses. In addition to the financial regulation fee, insurance companies are charged the examination expenses (travel and commuting expenses). Depending on the circumstances, expenses can be billed by the state to the company or by the examiner directly to the company. Because of staffing shortages and the difficulty in hiring examiners, the department’s examination staff is supplemented by outside consultants | No | Variable |

| | | | |
|---|---|---|---|
| | who bill the company under examination directly for fees and expenses. | | |
| Indiana | All examination costs are paid by the companies. | No | 1.3% |
| Iowa | Bills the cost of the exam which includes time and expenses to the company. | No | 1.25% |
| Kansas | Insurance companies pay directly for examinations. | No | 2% |
| Kentucky | Insurers bear the cost of an examination. | No | 2% |
| Louisiana | | | Variable |
| Maine | Insurance companies have the option of paying the actual examination expenses or an annual assessment based upon a percentage of the company's total admitted assets. | No | 2% |
| Maryland | Examinations are billed to the individual companies - a per diem rate for the examiners plus the associated travel costs. | No | 2% |
| Massachusetts | | | 2.28% |
| Michigan | Generally does not charge for examinations.  Insurance regulation is funded through assessments of all licensed insurers.  Sometimes charge for financial examinations when a domestic insurer moves their books and records out of state.  Those insurers must pay any additional cost incurred by the agency as a result of completing the examination in another state.  For out of state exams, the department hires outside firms to complete the exam. | No | Variable |
| Minnesota | Examination expenses are billed directly to the company under examination. | Yes | 2% |
| Mississippi | Use independent contract examiners that are paid directly by the insurance company | No | 3% |
| Missouri | Examination expenses are billed directly to the company under examination | Yes | 2% |
| Montana | Bill the company directly for examination expenses | No | 2.75% |
| Nebraska | | | 1% |
| Nevada | Division of Insurance recovers all costs of an examination from the examinee. | No | 3.5% |
| New Hampshire | Actual cost of the examination is invoiced to the company being examined. | No | 2% |
| New Jersey | The New Jersey Division of Insurance is funded by a dedicated 1/10 of 1% of premium taxes plus industry assessments.  Department examiners perform virtually all examinations and the costs are covered by these revenues: no billing of the subject insurer is made, even if a consultant is required on a particular job.  The department does, however, bill domestic insurers for the costs (examiner time and expenses; cost of any consultants required) of periodic financial exams, so as to avoid any retaliatory questions. | No | 2.1% |
| New Mexico | | | 3.003% |
| New York | Insurance companies are assessed an examiner billing fee for the amount of time examiners work on that particular company. | No | 2% |
| North Carolina | Examinations are funded by premium taxes and insurers are not billed for the cost of examinations unless | No | 1.9% |

| | | | |
|---|---|---|---|
| | they are a domestic insurer that maintains books and records outside the state of North Carolina. | | |
| North Dakota | Insurance companies being examined in North Dakota being pay the charges for an examination. | Yes | 1.75% |
| Ohio | The direct travel and time costs of the examiners are billed to the company on a reimbursement basis. | No | 1.4% |
| Oklahoma | Examination expenses exams are paid by the company being examined. | No | 2.25% |
| Oregon | Examination expenses are billed directly to the company being examined. | No | Variable |
| Pennsylvania | | | 2% |
| Rhode Island | | | 2% |
| South Carolina | | | 1.25% |
| South Dakota | | No | 2.5% |
| Tennessee | Department bills the company directly for cost of examinations. | No | 2.5% |
| Texas | | | 1.6% |
| Utah | | | 2.25% |
| Vermont | | | 2% |
| Virginia | The Bureau charges companies for the travel expenses association with an examination (meals, mileage, lodging, car rentals). Salaries for examiners are paid through the special funds levied against insurance companies that are used to fund the agency. | No | 2.25% |
| Washington | Exams are funded through a special assessment made on all licensed insurers in the state. Some exceptions to this, as some exams are directly billed, i.e. title. | No | 2% |
| West Virginia | | | 3% |
| Wisconsin | For Market Regulation exams, a cost sheet is maintained showing actual expenses incurred (hotel, meals, mileage, etc.) and hours of work related to the exam. Only on-site hours are billed to the company, not any pre-exam or post-exam hours, those costs are included with the Financial Bureau assessment process. This process is the same whether the examinee is a domestic or foreign company. For Financial examinations, the annual Financial Bureau budget (plus some administrative overhead) is billed to all of the domestic companies annually, in proportion to the square root of their net premiums written. There are minimum assessments and limits on the increase from the prior year. The domestic company examined does not pay any additional costs, as each domestic company pays a Financial Bureau exam assessment each year whether or not they are examined. If the department conducts a financial exam on a foreign company, the costs are directly billed. | No | Variable |
| Wyoming | Assesses each licensed insurer for its budget, and then pay examiners' salaries out of the budget. The formula for the department's assessment is the total annual budget divided by the number of insurers licensed in the state. | No | .75% |

**Office of Chief Counsel**
**Internal Revenue Service**
# Memorandum

Number: **200445046**

Release Date: 11/5/04

CC:ITA:1&3
POSTS-123179-04

Third Party Communication: State Government
Date of Communication: September 21, 2004
Date of Communication: October 21, 2004

UILC: 164.00-00

date: October 29, 2004

to: Associate Area Counsel
(Small Business/Self-Employed)
CC:SB:1:BOS

from: Acting Chief, Branch 1
Office of Associate Chief Counsel
(Income Tax and Accounting)
CC:ITA:1

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subject: Massachusetts Transferable Tax Credits

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUE

Whether the purchasers of Massachusetts historic rehabilitation tax credits and low-income housing tax credits have made a "payment," for purposes of § 164(a) of the Internal Revenue Code, when they file their state tax returns and use the purchased credits to reduce their state tax liability.

CONCLUSION

Such purchasers have made a payment for purposes of § 164(a) when they file their state tax returns and use the purchased credits to reduce their state tax liability.

FACTS

The following descriptions of the credits are based on our review of the relevant state statutes and regulations. Also, we contacted the Rulings and Regulations Bureau of the Massachusetts Department of Revenue to confirm our understanding of certain provisions.

Massachusetts Historic Rehabilitation Tax Credit

Chapters 62 and 63 of the Massachusetts General Laws provide, respectively, for an income tax and a corporate excise tax imposed on corporate net income. Section 6J of M.G.L. chapter 62 and § 38R of M.G.L. chapter 63 provide for a historic rehabilitation tax credit.[1] Section 6J applies to a person, firm, partnership, trust, estate, limited liability company, or other entity that is subject to the income tax imposed by chapter 62. Section 6J(a) (definition of "taxpayer"). Section 38R applies to a corporation or other entity that is subject to an excise tax imposed by chapter 63. Section 38R(a) (definition of "taxpayer"). See also § 63.38R.1(2).[2]

Pursuant to these provisions, the Commissioner of the Massachusetts Department of Revenue (MDOR), in consultation with the Massachusetts Historical Commission (MHC), will authorize annually, for the five year period beginning January 1, 2005, and ending December 31, 2009, an amount of credit not to exceed $10,000,000 per year. The MHC will determine the criteria for eligibility for the credit, which will be set forth in regulations. Sections 6J(b)(1)(i) and 38R(b)(1)(i). See also § 63.38R.1(3)(b).

The credit will be equal to a percentage, not to exceed 20 percent, of the qualified rehabilitation expenditures made by a taxpayer with respect to a qualified historic structure that has received final certification and has been placed in service. The MHC will administer, determine eligibility for, and allocate the credit. Sections 6J(b)(1)(ii) and 38R(b)(1)(ii). The credit will be allowed for the tax year in which the substantially rehabilitated property is placed in service. Any amount that exceeds the year's tax may be carried forward for up to five years. Sections 6J(b)(2) and 38R(b)(2). See also §§ 63.38R.1(9) and 63.38R.1(10). Credits allowed to a partnership, a limited liability company taxed as a partnership, or multiple owners of property will be passed through to the partners, members, or owners, respectively, either pro rata or pursuant to an executed agreement documenting an alternative distribution method. See §§ 6J(b)(2)(i) and 38R(b)(2)(i). See also § 63.38R.1(8).

If, before the end of the five year period beginning on the date on which the qualified historic structure received final certification and was placed in service, the taxpayer

[1] References to "section 6J" and "section 38R" in this memorandum are to the sections in M.G.L. chapters 62 and 63, respectively.

[2] On the date this memorandum was issued, 830 CMR § 63.38R.1 was an emergency regulation scheduled to expire on December 29, 2004. References to "§ 63.38R.1" in this memorandum are to this regulation.

disposes of its interest in the structure, the tax for the year in which the disposition occurs will be increased by a recapture amount and any carry forward will be adjusted. Sections 6J(g)(1) and 38R(g)(1). The state income tax return and corporate excise tax return forms contain a line to report recapture of credits. Transferees are not subject to recapture. Section 63.38R.1(12).

Taxpayers eligible for the credit may, with prior notice to the MDOR, transfer the credits, in whole or in part, to an individual or entity, and "the transferee will be entitled to apply the credits against tax with the same effect as if the transferee had incurred the qualified rehabilitation expenditures itself." The transferee must use the credit in the year it is transferred; any excess may be carried forward for up to five years after the close of the tax year during which the qualified historic structure received final certification and was placed in service. Sections 6J(b)(2)(ii) and 38R(b)(2)(ii). See also § 63.38R.1(10)(b).

Section 63.38R.1(7)(a) of 830 CMR, tracking the statutory provisions, states:

> Any taxpayer allowed to take the historic rehabilitation credit may transfer the credit, in whole or in part, to any individual or entity, without the requirement of transferring any ownership interest in the project or any interest in the entity which owns the project. Transferees are entitled to apply the credits against the tax or excise with the same effect as if the transferee had incurred the qualified rehabilitation expenditures. … The credit can be transferred only after the date a chosen project becomes a completed project.

The regulations require that the transferor enter into a transfer contract with the transferee of the credit. The transfer contract must include certain specified information. Section 63.38R.1(7)(c). The transferor must file a transfer statement form and a copy of the proposed transfer contract with the MDOR prior to the transfer, and file the executed transfer contract within 30 days after the transfer. Section 63.38R.1(7)(b). Any taxpayer who is a transferee of the credit may, provided all transfer and other requirements or limitations are met, apply the credit to either the income tax imposed under chapter 62 or the excise tax imposed under chapter 63. Section 63.38R.1(7)(d).

Although the statute and regulations are not explicit on these points, it appears that the credit is nonrefundable, and that transferees may choose either to use the credits or transfer them to other taxpayers.

Massachusetts Low-Income Housing Tax Credit

Section 6I of chapter 62 and § 31H of chapter 63 of the Massachusetts General Laws[3] provide for a low-income housing tax credit that supplements the credit provided for in

[3] References in this memorandum to "section 6I" and "section 31H" are to the sections in M.G.L. chapters 62 and 63, respectively.

§ 42 of the Internal Revenue Code. Section 6I applies to a person, firm, partnership, or other entity that is subject to the income tax imposed by chapter 62. Section 6I(a) (definition of "taxpayer"). Section 31H applies to corporations that are subject to an excise tax imposed by chapter 63. Section 31H(a) (definition of "taxpayer"). See also 760 CMR §§ 54.02 and 54.05.

The Massachusetts Department of Housing and Community Development (MDHCD), or its successor agency, may authorize annually, for the five year period beginning January 1, 2001, and ending December 31, 2005, the total sum of:

> (1) the lesser of 50 percent of the federal per capita tax credits awarded to the commonwealth pursuant to § 42 of the Internal Revenue Code or $4,000,000;
>
> (2) unused Massachusetts low-income housing tax credits, if any, for the preceding calendar years; and
>
> (3) any Massachusetts low-income housing tax credits returned to the MDHCD by a qualified Massachusetts project.

Sections 6I(b)(1) and 31H(b)(1). See also 760 CMR § 54.03. Generally, the MDHCD authorizes, administers, determines eligibility for, and allocates the Massachusetts low-income housing tax credit in accordance with the standards and requirements set forth in I.R.C. § 42. The combined federal and Massachusetts low-income housing tax credit is the least amount necessary to ensure financial feasibility. Sections 6I(b)(2) and 31H(b)(2). The MDHCD, in consultation with the MDOR, monitors and oversees compliance with the Massachusetts program. Sections 6I(g) and 31H(g).

The Massachusetts low-income housing tax credit is claimed equally for five years and is not refundable. Sections 6I(c)(3) and 31H(c)(3). See also 760 CMR § 54.03(2). Any amount of the credit that exceeds the tax due for a year may be carried forward to any of the five subsequent years. Sections 6I(c)(3) and 31H(c)(3). See also 760 CMR § 54.10. See 760 CMR §§ 54.08 and 54.09 for rules concerning the time for claiming the credit. See 760 CMR § 54.06 for rules concerning the allotment of credits to partners/members of flow-through entities and multiple owners of property.

If under I.R.C. § 42 a portion of any federal low–income housing tax credits taken on a low-income project must be recaptured, the Massachusetts low-income housing tax credit authorized with respect to such project is also recaptured; any credit not yet claimed is disallowed. See §§ 6I(d)(2) and 31H(d)(2); 760 CMR § 54.12(1). Transferees are subject to recapture. 760 CMR § 54.12(1). The amount of recapture shall be reported and subject to tax in the year during which the federal recapture occurs. 760 CMR § 54.12(4). The state income tax return and corporate excise tax return forms contain a line to report recapture of credits.

All or any portion of the credits may be transferred, sold, or assigned to taxpayers who have received an allocation of federal low-income housing tax credit. Sections 6I(f)(1)

and 31H(f)(1). An owner or transferee desiring to make a transfer, sale, or assignment must submit to the MDOR a statement that describes the amount of credit eligible for transfer, as well as appropriate information so that the credit can be properly allocated. Sections 6I(f)(2) and 31H(f)(2).

Section 54.07(1) of 760 CMR provides the following rules:

> Any taxpayer with an ownership interest in a qualified Massachusetts project with respect to which there has been allocated Massachusetts low-income housing tax credit and any taxpayer to whom the right to claim Massachusetts low-income housing tax credit has been allotted or transferred may transfer the right to claim unclaimed Massachusetts low-income housing tax credit to any other Massachusetts taxpayer eligible to claim a federal low-income housing tax credit with respect to the original or a different qualified Massachusetts project without the necessity of transferring any ownership interest in the original project or any interest in the entity which owns the original project. The transferor must transfer all credit attributable to periods after the transfer date agreed upon by the parties.

The regulations require that the transferor enter into a transfer contract with the transferee of the credit. The transfer contract must include certain specified information. 760 CMR § 54.07(2). The transferee may then claim the credit "notwithstanding the fact that the credit may initially have been allocated to a taxpayer paying a different income tax (i.e., personal or corporate)." 760 CMR § 54.07(3). The transferor must file a transfer statement form with the MDOR within 30 days after the transfer. Each taxpayer claiming the credit must file with each Massachusetts tax return on which the credit is claimed copies of all transfer statements and transfer contracts necessary to enable the MDOR to trace the claimed credit to the credit that was initially allocated with respect to the project. 760 CMR § 54.13(4).

LAW AND ANALYSIS

Section 164(a) of the Internal Revenue Code generally allows as a deduction certain types of taxes, listed in § 164(a)(1)-(5), that are paid or accrued within the tax year. See also § 1.164-1(a) of the Income Tax Regulations. Specifically, § 164(a)(3) provides for the deduction of state and local income taxes paid or accrued within the tax year. Additionally, § 164(a) provides for the deduction of state and local taxes not described in § 164(a)(1)-(5) that are paid or accrued within the tax year in carrying on a trade or business or an activity described in § 212 (relating to expenses for production of income). See also Rev. Rul. 70-561, 1970-2 C.B. 40 (Pennsylvania excise tax imposed on corporate net income is deductible under § 164(a)).

A transferee's payment to a transferor for the purchase of a transferable state tax credit is clearly not a payment of tax or a payment in lieu of tax for purposes of § 164(a). See

Rev. Ruls. 61-152, 1961-2 C.B. 42; 71-49, 1971-1 C.B. 103; 81-192, 1981-2 C.B. 49. In addition, generally the application of a credit against a tax liability is merely a reduction of the tax liability. See Rev. Rul. 79-315, 1979-2 C.B. 27. However, in this situation, a transferee has purchased a credit for value and the credit is “property” in the transferee’s hands rather than a factor in the calculation of tax due. The use of the credit to reduce the transferee’s state tax is analogous to the transfer of property to the state in satisfaction of the transferee’s tax liability. Thus, the transferee of a Massachusetts historic rehabilitation tax credit or low-income housing tax credit will have made a payment, for purposes of I.R.C. § 164(a), when it files its state tax return and uses the purchased credit to reduce its state tax liability.

Please call (202) 622-4950 if you have any further questions.